

VMWARE, INC.

Form 10-Q

May 04, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

Delaware

94-3292913

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

3401 Hillview Avenue

94304

Palo Alto, CA

(Zip Code)

(Address of principal executive offices)

(650) 427-5000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of April 28, 2015, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 423,862,844 of which 123,862,844 shares were Class A common stock and 300,000,000 were Class B common stock.

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	Three Months Ended March 31,	
	2015	2014
Revenues:		
License	\$576	\$561
Services	935	799
Total revenues	1,511	1,360
Operating expenses (1):		
Cost of license revenues	50	50
Cost of services revenues	193	151
Research and development	305	293
Sales and marketing	536	474
General and administrative	187	151
Realignment charges	22	—
Operating income	218	241
Investment income	12	9
Interest expense with EMC	(6	) (5
Other expense	(2) —
Income before income taxes	222	245
Income tax provision	26	46
Net income	\$196	\$199
Net income per weighted-average share, basic for Class A and Class B	\$0.46	\$0.46
Net income per weighted-average share, diluted for Class A and Class B	\$0.45	\$0.46
Weighted-average shares, basic for Class A and Class B	427,962	430,546
Weighted-average shares, diluted for Class A and Class B	430,496	434,729

(1) Includes stock-based compensation as follows:

Cost of license revenues	\$1	\$1
Cost of services revenues	11	9
Research and development	54	60
Sales and marketing	39	41
General and administrative	14	17

The accompanying notes are an integral part of the condensed consolidated financial statements.

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VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(unaudited)

	Three Months Ended March 31,	
	2015	2014
Net income	\$ 196	\$ 199
Other comprehensive income:		
Changes in market value of available-for-sale securities:		
Unrealized gains, net of taxes of \$4 and \$1	6	1
Changes in market value of effective foreign currency forward exchange contracts:		
Unrealized losses, net of \$0 taxes for all periods	(5) —
Total other comprehensive income	1	1
Total comprehensive income, net of taxes	\$ 197	\$ 200

The accompanying notes are an integral part of the condensed consolidated financial statements.

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VMware, Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$1,941	\$2,071
Short-term investments	5,285	5,004
Accounts receivable, net of allowance for doubtful accounts of \$2 and \$2	988	1,520
Due from related parties, net	2	49
Deferred tax assets	250	248
Other current assets	239	238
Total current assets	8,705	9,130
Property and equipment, net	1,059	1,035
Other assets	168	174
Deferred tax assets	175	165
Intangible assets, net	719	748
Goodwill	3,981	3,964
Total assets	\$14,807	\$15,216
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$124	\$203
Accrued expenses and other	680	811
Unearned revenues	2,970	2,982
Total current liabilities	3,774	3,996
Notes payable to EMC	1,500	1,500
Unearned revenues	1,774	1,851
Other liabilities	275	283
Total liabilities	7,323	7,630
Contingencies (refer to Note I)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 125,556 and 129,359 shares	1	1
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3
Additional paid-in capital	3,082	3,380
Accumulated other comprehensive loss	—	(1)
Retained earnings	4,394	4,198
Total VMware, Inc.'s stockholders' equity	7,480	7,581
Non-controlling interests	4	5
Total stockholders' equity	7,484	7,586
Total liabilities and stockholders' equity	\$14,807	\$15,216
The accompanying notes are an integral part of the condensed consolidated financial statements.		

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VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Three Months Ended	
	March 31,	
	2015	2014
Operating activities:		
Net income	\$196	\$199
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	76	83
Stock-based compensation	119	128
Excess tax benefits from stock-based compensation	(2	) (15
Deferred income taxes, net	(15	) (29
Other	—	1
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	531	418
Other assets	—	(29
Due to/from related parties, net	52	33
Accounts payable	(49	) (11
Accrued expenses	(102	) (104
Income taxes payable	(32	) 41
Unearned revenues	(91	) 35
Net cash provided by operating activities	683	750
Investing activities:		
Additions to property and equipment	(106	) (77
Purchases of available-for-sale securities	(1,027	) (531
Sales of available-for-sale securities	501	411
Maturities of available-for-sale securities	255	153
Business acquisitions, net of cash acquired	(21	) (1,068
Decrease (increase) in restricted cash	1	(76
Other investing	—	(10
Net cash used in investing activities	(397	) (1,198
Financing activities:		
Proceeds from issuance of common stock	54	88
Proceeds from issuance of notes payable to EMC	—	1,050
Reduction in capital from EMC	—	(24
Repurchase of common stock	(438	) (169
Excess tax benefits from stock-based compensation	2	15
Shares repurchased for tax withholdings on vesting of restricted stock	(34	) (29
Net cash provided by (used in) financing activities	(416	) 931
Net increase (decrease) in cash and cash equivalents	(130	) 483
Cash and cash equivalents at beginning of the period	2,071	2,305
Cash and cash equivalents at end of the period	\$1,941	\$2,788
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$7	\$6
Cash paid for taxes, net	74	33
Non-cash items:		
Changes in capital additions, accrued but not paid	\$(42	) \$(7

Fair value of stock-based awards assumed in acquisition — 24
The accompanying notes are an integral part of the condensed consolidated financial statements.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is the leader in virtualization infrastructure solutions utilized by organizations to help them transform the way they build, deliver and consume information technology (“IT”) resources. VMware’s virtualization infrastructure solutions, which include a suite of products and services designed to deliver a software-defined data center, run on industry-standard desktop computers and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”).

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2015. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2014 Annual Report on Form 10-K.

As of March 31, 2015, EMC Corporation (“EMC”) held approximately 80.6% of VMware’s outstanding common stock and 97.4% of the combined voting power of VMware’s outstanding common stock, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with EMC may not be considered arm’s length with an unrelated third party. Therefore, the financial statements included herein may not necessarily reflect the financial position, results of operations and cash flows had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware’s historical financial information is not necessarily indicative of what the Company’s financial position, results of operations and cash flows will be in the future if and when VMware contracts at arm’s length with unrelated third parties for the services the Company receives from and provides to EMC.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. Non-controlling interests are presented as a separate component within total stockholders’ equity and represent the equity and cumulative pro-rata share of the results of operations attributable to the non-controlling interests. Net earnings attributable to the non-controlling interests are eliminated within other expense on the condensed consolidated statements of income and are not presented separately as the amounts were not material for the periods presented. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with EMC and its subsidiaries are generally settled in cash and are classified on the condensed consolidated statements of cash flows based upon the nature of the underlying transaction.

Reclassification

Certain prior period amounts related to the notes payable to EMC have been reclassified within the financing activities section of the condensed consolidated statements of cash flows. The reclassifications had no effect on total cash flows

used in or provided by operating, investing or financing activities as previously reported.

Use of Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements.

Estimates are used for, but

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

not limited to trade receivable valuation, marketing development funds and rebates, useful lives assigned to fixed assets and intangible assets, valuation of goodwill and definite-lived intangibles, income taxes, stock-based compensation, and contingencies. Actual results could differ from those estimates.

New Accounting Pronouncement

During May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. Upon adoption, entities will be required to recognize the amount of revenue that they expect to be entitled to for the transfer of promised goods or services to their customers. The updated standard is effective for the Company in the first quarter of 2017 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted. In April 2015, the FASB proposed a one-year delay in the effective date of the new standard to 2018. Under this proposal, early adoption will be allowed, but not earlier than the original effective date.

The Company has not selected a transition method and is currently evaluating the effect that the updated standard will have on its condensed consolidated financial statements and related disclosures.

B. Business Combination, Definite-Lived Intangible Assets, Net and Goodwill**Business Combination**

On February 2, 2015, VMware acquired all of the outstanding shares of Immidio B.V. (“Immidio”) for approximately \$21 million of cash, net of liabilities assumed. VMware acquired Immidio to expand VMware's Workspace Environment Management solutions within the End-User Computing product group. The preliminary purchase price primarily included \$8 million of identifiable intangible assets and approximately \$17 million of goodwill that is expected to be non-deductible for tax purposes. The impact of the acquisition was not material to VMware's condensed consolidated financial statements.

Definite-Lived Intangible Assets, Net

As of March 31, 2015 and December 31, 2014, definite-lived intangible assets consisted of the following (amounts in table in millions):

	March 31, 2015			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	\$705	\$(279)	) \$426
Leasehold interest	34.9	149	(16)	) 133
Customer relationships and customer lists	8.2	157	(58)	) 99
Trademarks and tradenames	8.6	61	(11)	) 50
Other	2.1	20	(9)	) 11
Total definite-lived intangible assets		\$1,092	\$(373)	) \$719
	December 31, 2014			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	\$699	\$(252)	) \$447
Leasehold interest	34.9	149	(15)	) 134
Customer relationships and customer lists	8.2	157	(53)	) 104
Trademarks and tradenames	8.6	61	(9)) 52
Other	2.7	18	(7)) 11
Total definite-lived intangible assets		\$1,084	\$(336)) \$748

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During the three months ended March 31, 2015 and 2014, amortization expense on definite-lived intangible assets was \$37 million and \$30 million, respectively.

Based on intangible assets recorded as of March 31, 2015 and assuming no subsequent additions or impairment of underlying assets, the remaining estimated annual amortization expense is expected to be as follows (table in millions):

Remainder of 2015	\$109
2016	128
2017	121
2018	108
2019	87
Thereafter	166
Total	\$719

Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the three months ended March 31, 2015 (table in millions):

Balance, January 1, 2015	\$3,964
Increase in goodwill related to business combination	17
Balance, March 31, 2015	\$3,981

C. Realignment Charges

During the three months ended March 31, 2015, VMware eliminated approximately 350 positions across all major functional groups and geographies to streamline its operations. As a result of this action, \$22 million of realignment charges were recognized during the three months ended March 31, 2015, which consisted of severance-related costs. As of March 31, 2015, \$16 million remained in accrued expenses and other on the condensed consolidated balance sheets and is expected to be paid during 2015.

The following table summarizes the activity for the accrued realignment charges for the three months ended March 31, 2015 (table in millions):

	For the Three Months Ended March 31, 2015			
	Balance as of January 1, 2015	Realignment Charges	Utilization	Balance as of March 31, 2015
Severance-related costs	\$8	\$22	\$(14)	) \$16

No realignment charges were recognized during the three months ended March 31, 2014.

D. Net Income per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include unvested restricted stock units, performance stock units, stock options and purchase options under VMware's employee stock purchase plan. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate net income per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table sets forth the computations of basic and diluted net income per share during the three months ended March 31, 2015 and 2014 (net income in millions, shares in thousands):

	Three Months Ended	
	March 31,	
	2015	2014
Net income	\$196	\$199
Weighted-average shares, basic for Class A and Class B	427,962	430,546
Effect of dilutive securities	2,534	4,183
Weighted-average shares, diluted for Class A and Class B	430,496	434,729
Net income per weighted-average share, basic for Class A and Class B	\$0.46	\$0.46
Net income per weighted-average share, diluted for Class A and Class B	\$0.45	\$0.46

The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted net income per share calculations during the three months ended March 31, 2015 and 2014, because their effect would have been anti-dilutive (shares in thousands):

	Three Months Ended	
	March 31,	
	2015	2014
Anti-dilutive securities:		
Employee stock options	2,503	930
Restricted stock units	223	35
Total	2,726	965

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

E. Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments as of March 31, 2015 and December 31, 2014 consisted of the following (tables in millions):

	March 31, 2015			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$827	\$—	\$—	\$827
Cash equivalents:				
Money-market funds	\$1,082	\$—	\$—	\$1,082
U.S. and foreign corporate debt securities	32	—	—	32
Total cash equivalents	\$1,114	\$—	\$—	\$1,114
Short-term investments:				
U.S. Government and agency obligations	\$665	\$2	\$—	\$667
U.S. and foreign corporate debt securities	3,322	8	(2	) 3,328
Foreign governments and multi-national agency obligations	28	—	—	28
Municipal obligations	908	2	—	910
Asset-backed securities	87	—	—	87
Mortgage-backed securities	265	—	—	265
Total short-term investments	\$5,275	\$12	\$(2	) \$5,285
Other assets:				
Marketable available-for-sale equity securities	\$15	\$—	\$(1	) \$14
	December 31, 2014			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$885	\$—	\$—	\$885
Cash equivalents:				
Money-market funds	\$1,130	\$—	\$—	\$1,130
U.S. and foreign corporate debt securities	54	—	—	54
Foreign governments and multi-national agency obligations	2	—	—	2
Total cash equivalents	\$1,186	\$—	\$—	\$1,186
Short-term investments:				
U.S. Government and agency obligations	\$542	\$—	\$—	\$542
U.S. and foreign corporate debt securities	3,236	3	(5	) 3,234
Foreign governments and multi-national agency obligations	23	—	—	23
Municipal obligations	930	2	—	932
Asset-backed securities	53	—	—	53
Mortgage-backed securities	221	—	(1	) 220
Total short-term investments	\$5,005	\$5	\$(6	) \$5,004

Refer to Note F for further information regarding the fair value of VMware's cash equivalents and investments. The realized gains and losses on investments during the three months ended March 31, 2015 and 2014 were not material.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Unrealized losses on cash equivalents and investments as of March 31, 2015 and December 31, 2014, which have been in a net loss position for less than twelve months, were classified by investment category as follows (table in millions):

	March 31, 2015		December 31, 2014	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and foreign corporate debt securities	\$1,041	\$(2)	\$1,964	\$(5)
Mortgage-backed securities	93	—	107	(1)
Marketable available-for-sale equity securities	14	(1)	—	—
Total	\$1,148	\$(3)	\$2,071	\$(6)

As of March 31, 2015 and December 31, 2014, unrealized losses on cash equivalents and investments in other investment categories, which have been in a net loss position for less than twelve months, were not material.

Unrealized losses on cash equivalents and available-for-sale investments, which have been in a net loss position for twelve months or greater, were not material as of March 31, 2015 and December 31, 2014.

Contractual Maturities

The contractual maturities of cash equivalents and short-term investments held at March 31, 2015 consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	\$2,632	\$2,633
Due after 1 year through 5 years	3,470	3,479
Due after 5 years	287	287
Total cash equivalents and short-term investments	\$6,389	\$6,399

F. Fair Value Measurements**Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis**

Certain financial assets and liabilities are measured at fair value on a recurring basis. VMware determines fair value using the following hierarchy:

Level 1 - Quoted prices in active markets for identical assets or liabilities

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are noted active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

VMware's fixed income securities are primarily classified as Level 2, with the exception of some of the U.S.

Government and agency obligations which are classified as Level 1. Additionally, VMware's Level 2 classification includes foreign currency forward contracts and notes payable to EMC. At March 31, 2015 and December 31, 2014, VMware's Level 2 securities were generally priced using non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques.

VMware does not have any material assets or liabilities that fall into Level 3 of the fair value hierarchy as of March 31, 2015 and December 31, 2014, and there have been no transfers between fair value measurement levels during the three months ended March 31, 2015 and 2014.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following tables set forth the fair value hierarchy of VMware's money-market funds, available-for-sale securities, and foreign currency forward contracts, that were required to be measured at fair value as of March 31, 2015 and December 31, 2014 (tables in millions):

	March 31, 2015		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$1,082	\$—	\$1,082
U.S. and foreign corporate debt securities	—	32	32
Total cash equivalents	\$1,082	\$32	\$1,114
Short-term investments:			
U.S. Government and agency obligations	\$436	\$231	\$667
U.S. and foreign corporate debt securities	—	3,328	3,328
Foreign governments and multi-national agency obligations	—	28	28
Municipal obligations	—	910	910
Asset-backed securities	—	87	87
Mortgage-backed securities	—	265	265
Total short-term investments	\$436	\$4,849	\$5,285
Other current assets:			
Foreign currency forward contracts	\$—	\$1	\$1
Other assets:			
Marketable available-for-sale equity securities	\$14	\$—	\$14
Accrued expenses and other:			
Foreign currency forward contracts	\$—	\$(7)	\$(7)
	December 31, 2014		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$1,130	\$—	\$1,130
U.S. and foreign corporate debt securities	—	54	54
Foreign governments and multi-national agency obligations	—	2	2
Total cash equivalents	\$1,130	\$56	\$1,186
Short-term investments:			
U.S. Government and agency obligations	\$353	\$189	\$542
U.S. and foreign corporate debt securities	—	3,234	3,234
Foreign governments and multi-national agency obligations	—	23	23
Municipal obligations	—	932	932
Asset-backed securities	—	53	53
Mortgage-backed securities	—	220	220
Total short-term investments	\$353	\$4,651	\$5,004
Other current assets:			
Foreign currency forward contracts	\$—	\$1	\$1
Accrued expenses and other:			
Foreign currency forward contracts	\$—	\$(1)	\$(1)

VMware has elected not to record its notes payable to EMC at fair value, but has measured the notes at fair value for disclosure purposes. As of March 31, 2015 and December 31, 2014, the fair value of the notes payable to EMC was \$1,519 million and \$1,503 million, respectively. Fair value was estimated based on observable market data (Level 2 inputs).

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

VMware offers a deferred compensation plan for eligible employees that allows participants to defer payment for part or all of their compensation. VMware's results of operations are not significantly affected by this plan since changes in the fair value of the assets substantially offset changes in the fair value of the liabilities. As such, assets and liabilities associated with this plan have not been included in the above tables. Assets and liabilities associated with this plan were both approximately \$13 million and \$8 million as of March 31, 2015 and December 31, 2014, respectively, and are included in other assets and other liabilities on the condensed consolidated balance sheets.

Assets Measured and Recorded at Fair Value on a Non-Recurring Basis

VMware evaluated the strategic investments in its portfolio accounted for under the cost method to assess whether any of its strategic investments were other-than-temporarily impaired. VMware uses Level 3 inputs as part of its impairment analysis, including, pre- and post-money valuations of recent financing events and the impact of those on its fully diluted ownership percentages, as well as other available information regarding the issuer's historical and forecasted performance. The estimated fair value of these investments is considered in VMware's impairment review if any events or changes in circumstances occur that might have a significant adverse effect on their value. During the three months ended March 31, 2015 and 2014, VMware did not recognize an other-than-temporary impairment charge for a non-recoverable strategic investment.

During the three months ended March 31, 2015 and 2014, VMware did not have material realized gains or realized losses on strategic investments. Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware's strategic investments was \$94 million and \$110 million as of March 31, 2015 and December 31, 2014, respectively.

G. Derivatives and Hedging Activities

VMware conducts business on a global basis in multiple foreign currencies, subjecting the Company to foreign currency risk. To mitigate this risk, VMware utilizes hedging contracts as described below, which potentially expose the Company to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. VMware manages counterparty risk by seeking counterparties of high credit quality, by monitoring credit ratings and credit spreads of, and other relevant public information about its counterparties. VMware does not, and does not intend to, use derivative instruments for speculative purposes.

Cash Flow Hedges

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware enters into foreign currency forward contracts. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation have been met. Therefore, the effective portion of gains or losses resulting from changes in the fair value of these hedges is initially reported in accumulated other comprehensive loss on the condensed consolidated balance sheets and is subsequently reclassified to the related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. During the three months ended March 31, 2015 and 2014, the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not material. Interest charges or "forward points" on VMware's forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other expense on the condensed consolidated statements of income as incurred.

VMware enters into forward contracts annually, which have maturities of 12 months or less. As of March 31, 2015 and December 31, 2014, VMware had foreign currency forward contracts designated as cash flow hedges with a total notional value of \$178 million and \$240 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

During the three months ended March 31, 2015 and 2014, all cash flow hedges were considered effective.

Foreign Currency Forward Contracts Not Designated as Hedges

VMware has established a program that utilizes foreign currency forward contracts to offset the foreign currency risk associated with net outstanding monetary asset and liability positions. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward

contracts are reported in other expense on the condensed consolidated statements of income.

VMware enters into foreign currency forward contracts on a monthly basis, which typically have a contractual term of one month. As of March 31, 2015 and December 31, 2014, VMware had outstanding forward contracts with a total notional value of \$489 million and \$697 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

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During the three months ended March 31, 2015, VMware recognized a gain of \$40 million relating to the settlement of foreign currency forward contracts. Losses derived from the settlement of foreign currency forward contracts during the three months ended March 31, 2014 were immaterial.

The combined gains and losses derived from the settlement of foreign currency forward contracts and the underlying foreign-currency denominated assets and liabilities resulted in a net loss of \$6 million during the three months ended March 31, 2015. The combined gains and losses derived from the settlement of foreign currency forward contracts and the underlying foreign-currency denominated assets and liabilities were immaterial during the three months ended March 31, 2014. Net gains and losses are recorded in other expense on the condensed consolidated statements of income.

H. Unearned Revenues

Unearned revenues as of March 31, 2015 and December 31, 2014 consisted of the following (table in millions):

	March 31, 2015	December 31, 2014
Unearned license revenues	\$466	\$488
Unearned software maintenance revenues	3,847	3,905
Unearned professional services revenues	431	440
Total unearned revenues	\$4,744	\$4,833

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or are otherwise recognized ratably over the term of the arrangement. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence (“VSOE”) of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services, unearned license revenues may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist. Total unearned license revenues may vary over periods for a variety of factors, including the type and level of promotions offered, and the timing of when the products are delivered upon general availability.

Unearned software maintenance revenues are attributable to VMware’s maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at March 31, 2015 was approximately 1.9 years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

I. Contingencies**Litigation**

VMware and the U.S. General Services Administration (“GSA”) and the Department of Justice (“DOJ”) are in ongoing discussions regarding VMware’s government sales practices covering the period between 2007 and 2013. The Company believes that its government sales practice disclosures were both accurate and complete. Notwithstanding this belief, possible resolution of this matter has been part of the ongoing discussions with the government. Based on these discussions, the Company currently believes that a reasonably possible range to resolve this matter is \$11 million to \$78 million. A total of \$11 million has been accrued for this matter and reflects the low end of the range of estimated losses that are considered both probable and reasonably estimable. Final resolution of this matter could be materially different from the amount accrued. The amount accrued for this matter is included in accrued expenses and other on the condensed consolidated balance sheets.

On March 4, 2015, Christoph Hellwig, a software developer who alleges that software code he wrote is used in a component of our vSphere product, filed a lawsuit against us in Germany alleging copyright infringement for failing to comply with the terms of an open source General Public License v.2 (“GPL v.2”), and seeking an order requiring us to comply with the GPL v.2 or cease distribution of any affected code within Germany. VMware believes that it has

meritorious defenses in connection with this lawsuit, and currently a reasonably possible loss or range of loss cannot be estimated.

On March 27, 2015, Phoenix Technologies (“Phoenix”) filed a complaint against VMware in the U.S. District Court for the Northern District of California asserting claims for copyright infringement and breach of contract relating to a version of Phoenix’s BIOS software that VMware licensed from Phoenix. In the lawsuit, Phoenix is seeking injunctive relief and

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monetary damages. VMware believes that it has meritorious defenses in connection with this lawsuit, and currently a reasonably possible loss or range of loss cannot be estimated.

VMware accrues for a liability at the low end of the range of estimated losses when a determination has been made that a loss is both probable and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination that the occurrence of a loss is probable and is reasonably estimable. In making such judgments, VMware considers the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal costs are generally recognized as expense when incurred.

VMware believes that it has valid defenses against each of the legal matters disclosed. However, given the unpredictable nature of legal proceedings, an unfavorable resolution of one or more legal proceedings, claims, or investigations could have a material adverse effect on VMware's condensed consolidated financial statements. VMware is also subject to other legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to commercial, product liability, intellectual property, employment, class action, whistleblower and other matters. From time to time, VMware also receives inquiries from and has discussions with government entities on various matters. VMware does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on its condensed consolidated financial statements.

J. Stockholders' Equity

VMware Stock Repurchases

On January 27, 2015, VMware's Board of Directors authorized the repurchase of up to an additional one billion dollars of VMware's Class A common stock through the end of 2017. Stock will be purchased from time to time, in the open market or through private transactions, subject to market conditions. The new stock repurchase authorization is in addition to VMware's ongoing one-billion-dollar stock repurchase program, originally announced on August 6, 2014. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including VMware's stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. VMware is not obligated to purchase any shares under its stock repurchase programs. Purchases can be discontinued at any time VMware believes additional purchases are not warranted. All shares repurchased under VMware's stock repurchase programs are retired.

The following table summarizes stock repurchase authorizations that remain open as of March 31, 2015 (amounts in table in millions):

Authorization Date	Amount Authorized	Expiration Date	Status
January 27, 2015	\$1,000	December 31, 2017	Open
August 6, 2014	\$1,000	December 31, 2016	Open

As of March 31, 2015, the cumulative authorized amount remaining for repurchase was \$1,521 million.

The following table summarizes stock repurchase activity during the three months ended March 31, 2015 and 2014 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended March 31,	
	2015	2014
Aggregate purchase price	\$438	\$169
Class A common shares repurchased	5,366	1,767
Weighted-average price per share	\$81.65	\$95.56

The aggregate purchase price of repurchased shares includes commissions and is classified as a reduction to additional paid-in capital.

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VMware Stock Options

The following table summarizes stock option activity since January 1, 2015 (shares in thousands):

	Number of Shares	Weighted- Average Exercise Price (per share)
Outstanding, January 1, 2015	5,869	\$50.54
Granted	13	84.68
Forfeited	(82	) 75.58
Exercised	(273	) 23.12
Outstanding, March 31, 2015	5,527	51.63

The stock options outstanding as of March 31, 2015 had an aggregate intrinsic value of \$185 million based on VMware's closing price as of March 31, 2015.

VMware Restricted Stock

VMware's restricted stock primarily consists of restricted stock unit ("RSU") awards granted to employees. RSUs are valued based on VMware's stock price on the date of grant. The shares underlying the RSU awards are not issued until the RSUs vest. Upon vesting, each RSU converts into one share of VMware Class A common stock.

VMware's restricted stock also includes performance stock unit ("PSU") awards, which have been granted to certain of VMware's executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based vesting component. Upon vesting, each PSU award will convert into VMware's Class A common stock at various ratios ranging from 0.5 to 2.0 shares per PSU, depending upon the degree of achievement of the performance target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued. As of March 31, 2015, the number of PSUs outstanding includes certain PSUs for which performance conditions have concluded but that remain subject to certain service conditions.

The following table summarizes restricted stock activity since January 1, 2015 (units in thousands):

	Number of Units	Weighted- Average Grant Date Fair Value (per unit)
Outstanding, January 1, 2015	12,585	\$88.88
Granted	1,132	82.54
Vested	(939	) 81.85
Forfeited	(539	) 88.06
Outstanding, March 31, 2015	12,239	87.87

As of March 31, 2015, the 12.2 million units outstanding included 11.7 million of RSUs and restricted stock, and 0.5 million of PSUs. The above table includes RSUs issued for outstanding unvested RSUs in connection with business combinations.

The total fair value of VMware RSUs, restricted stock, and PSUs that vested during the three months ended March 31, 2015 was \$77 million. As of March 31, 2015, restricted stock representing 12.2 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of \$1,004 million based on VMware's closing price as of March 31, 2015.

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(unaudited)

Accumulated Other Comprehensive Income (Loss)

The changes in components of accumulated other comprehensive income (loss) during the three months ended March 31, 2015 and 2014 were as follows (tables in millions):

	Unrealized Gain on Available-for-Sale Securities	Unrealized Loss on Cash Flow Hedges	Total
Balance, January 1, 2015	\$—	\$(1	) \$(1
Unrealized gain (loss), net of taxes of \$4, \$0, and \$4	6	(5	) 1
Balance, March 31, 2015	\$6	\$(6) \$—
	Unrealized Gain on Available-for-Sale Securities		Total
Balance, January 1, 2014	\$4		\$4
Unrealized gain, net of taxes of \$1 and \$1	1		1
Balance, March 31, 2014	\$5		\$5

Gains on VMware's available-for-sale securities are reclassified to investment income on the condensed consolidated statements of income in the period that such gains are realized.

The effective portion of gains (losses) resulting from changes in the fair value of forward contracts designated as cash flow hedging instruments are reclassified to its related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. The amounts recorded to their related operating expense line items on the condensed consolidated statements of income during the three months ended March 31, 2015 and 2014, were not material.

K. Related Parties

The information provided below includes a summary of the transactions entered into with EMC and EMC's consolidated subsidiaries (collectively "EMC"). EMC acquired VCE Company LLC ("VCE") during the fourth quarter of 2014. Transactions with VCE from the date EMC acquired the controlling interest in VCE have been included in the tables below.

Transactions with EMC

VMware and EMC engaged in the following ongoing intercompany transactions, which resulted in revenues and receipts and unearned revenues for VMware:

- Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end users.

- EMC purchases products and services from VMware for internal use.

- VMware provides professional services to end users based upon contractual agreements with EMC.

- From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and EMC pays VMware for services that VMware provides to EMC in connection with such projects.

- Pursuant to an ongoing distribution agreement, VMware acts as the selling agent for certain products and services in exchange for an agency fee.

- VMware provides various transition services to Pivotal Software, Inc. ("Pivotal"), a subsidiary of EMC. Support costs incurred by VMware are reimbursed to VMware and are recorded as a reduction to the costs incurred by VMware.

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Information about VMware's revenues and receipts from such arrangements with EMC during the three months ended March 31, 2015 and 2014 and unearned revenues as of March 31, 2015 and December 31, 2014 consisted of the following (table in millions):

	Revenues and Receipts from EMC		Unearned Revenues from EMC	
	Three Months Ended March 31,		As of March 31,	As of December 31,
	2015	2014	2015	2014
Reseller revenues	\$61	\$46	\$272	\$290
Internal-use revenues	3	7	16	18
Professional services revenues	23	23	3	9
Collaborative technology project receipts	—	—	n/a	